

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Hertzberg Analyst: Marion Mann DeJong Bill Number: AB 1392

Related Bills: AB 2678 (1997/98); Telephone: 845-6979 Introduced Date: 02/26/1999

AB 41 (1999/00) Attorney: Doug Bramhall Sponsor: _____

SUBJECT: Action To Determine Validity Of Amount Of Tax

SUMMARY

This bill would allow a taxpayer to bring an action to determine the validity of a tax, or other amount assessed by the Franchise Tax Board (FTB), by filing a statement with the Attorney General (AG) and either paying the amount due or posting a bond to guarantee payment of the amount due.

This bill would add corresponding provisions that would apply to the Board of Equalization (BOE).

EFFECTIVE DATE

This bill would become effective on January 1, 2000.

SPECIFIC FINDINGS

Under current federal law, taxpayers must first attempt to resolve objections to IRS audit findings through the IRS administrative process. In the event the IRS is unable to reach agreement with the taxpayer, the taxpayer may either: (1) seek prepayment judicial review of the assessment in Tax Court (which has a small claims division for amounts of \$50,000 or less), or (2) pay the assessment and file a formal claim for refund with the IRS and appeal any action to a U.S. district court or claims court.

Current federal law allows a taxpayer to file a petition with the Tax Court for a redetermination of a deficiency within 90 days (150 days if addressed to persons outside the United States) after the notice of deficiency is mailed. No final assessment of a deficiency may be made until after the expiration of the 90-day period, or if petition is filed, until the decision of the Tax Court is final.

Current federal procedures (Rev. Proc. 84-58) allow a deposit in the nature of a cash bond while a deficiency is pending in administrative proceedings or Tax Court. The bond amount may be refunded without interest at any time, and if the taxpayer prevails in administrative proceedings, the entire bond may be refunded to the taxpayer without interest. This is an important strategic tool for taxpayers because a taxpayer can make a payment in the nature of a cash bond to stop the accrual of interest while preserving the jurisdiction of the Tax Court to review the underlying deficiency. A Tax Court decision can be appealed all the way to the Supreme Court without payment of the deficiency. However, collection of amounts affirmed by the Tax Court is not stayed during appellate review when a bond is posted with the court.

Board Position:

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_____ N	_____ OUA	<u> X </u> PENDING

Department Director

Date

Gerald Goldberg

4/6/1999

Under federal law and procedures, if during the administrative review or appeals process a taxpayer pays the deficiency rather than posting a cash bond, no deficiency is issued and taxpayers are precluded from challenging the assessment in Tax Court. The taxpayer must start over from the beginning with a refund claim that is treated as a new case. The taxpayer must then appeal any IRS action on the new refund claim to an U.S. district court or the U.S. Court of Claims rather than the Tax Court.

Current federal law generally prohibits injunctions against collection of taxes. Exceptions apply to enjoin premature assessment, levies, and collection action (i.e., IRS tries to collect a deficiency while a case is pending in Tax Court), to enjoin certain levies or sales, and to recover property wrongfully seized.

Under current state law, if the taxpayer disputes a proposed assessment, the taxpayer's administrative remedies allow the taxpayer to either (1) protest the proposed deficiency assessment or jeopardy assessment by filing a written "protest" with the FTB¹, or (2) pay the proposed assessment and file a claim for refund. Once the tax is paid, taxpayers have the longer of one year from the date of payment or four years from the date the original return was due to file a formal claim for refund to assert all bases for their dispute. If the claim is denied or no action is taken on the claim within six months the taxpayer may further pursue an administrative remedy by an appeal to the BOE or initiate legal action for a refund in superior court.

The taxpayer's administrative forum for appealing an adverse FTB action is the BOE. The BOE is the first independent administrative level of review of an FTB action. During the appeal process, the BOE makes an independent determination of the action. The BOE accepts evidence submitted by the taxpayer and, if requested by the taxpayer, grants an oral hearing on the matter. In the event of a final adverse BOE decision on appeal, the proposed deficiency is assessed, and the taxpayer's recourse is to pay the amount asserted to be due and bring an action for refund against the state in superior court.

Generally, under California law, no action may be maintained to enjoin the collection of tax. After full payment of all tax liability for the year, a refund claim can be filed and a suit for refund maintained.

State law, like federal law, provides that no injunction or writ of mandate or other legal or equitable process shall issue in any suit, action, or proceeding in any court to prevent or enjoin the assessment or collection of any tax. An exception is provided for suits contesting a *residency determination*. Such suits can be filed in superior court without payment of the computed tax liability. The taxpayer must first protest the proposed deficiency assessment with the FTB, and if unsuccessful, then file an appeal with the BOE. If the BOE determines that the taxpayer is a resident, a suit may be filed in superior court without payment of the tax within 60 days after the action of the BOE becomes final. No collection action may be taken while the suit is pending.

¹ The protest of a proposed deficiency or the appeal of FTB's denial of a taxpayer's protest may be converted to a claim for refund upon payment of the underlying deficiency, without the necessity of starting a new administrative process.

The California Constitution (Article XIII, Section 32) provides that no legal or equitable process shall issue in any proceeding in any court to prevent or enjoin the collection of any tax. The taxpayer's remedy is to pay the tax² and seek a refund.

Current department practice with respect to payments of tax made during an audit is to treat them as payments for the year in question and to show them as payments reducing the balance due when a proposed deficiency assessment is finally issued. If the payments exceed the proposed assessment amount, the excess is refunded with interest.

If a taxpayer wants to post a "cash bond" rather than make a payment of tax, **current department procedures** treat such payments as "voluntary payments" that do not earn interest. However, this is an unusual occurrence because it is beneficial to the taxpayer to have the payment designated as a payment of tax, so that interest can be paid on the overpayment in the event the taxpayer is successful.

This bill would allow a taxpayer to bring an action to determine the validity of a tax or other amount assessed by the FTB. To bring an action, the taxpayer must (1) file a statement with the AG not later than five days before the date the action is filed, providing the grounds challenging the validity of the tax or other assessed amount, and (2) either pay to FTB all amounts due or post a bond with FTB to guarantee payment of amounts due.

This bill would require the amount and terms of the bond and the sureties on the bond to be approved by and acceptable to the judge of the court hearing the action and the AG. The bill provides that approval should not be unreasonably withheld. If bond is approved, no collection action on the tax or other assessed amount may be taken while the action is pending.

This bill would require the plaintiff (or the plaintiff's agent or attorney) to state under oath that the required statements challenging the validity of the tax or assessed amount were provided to the AG and that payment was made or a bond was posted.

Legal Considerations

The provisions of this bill are susceptible to constitutional challenge since the California Constitution (Article XIII, Section 32) specifically provides that no legal or equitable process shall issue in any proceeding in any court to prevent or enjoin the collection of any tax. If a taxpayer posts a bond, rather than paying all amounts due, and brings an action, this bill would prevent collection while that action is pending. However, according to the author's staff, Legislative Counsel has verbally opined that this bill would not violate Article XIII, Section 32.

² The California Supreme court is currently considering whether interest as well as tax must be paid in the case of Agnew v. SBE.

Policy Considerations

This provision would raise the following policy considerations.

- This bill allows a taxpayer to stop collection of a tax until the validity of the tax is adjudicated in court. In some instances, adjudication and potential appeals can take many years. While posting a bond may ensure eventual payment of taxes and interest in the event the taxpayer loses, the State would not have the revenue available while the litigation is pending.
- While this bill would allow taxpayers to proceed to court at a reduced cost (bonds typically can be obtained for a fraction of their face value, like bail bonds), the purpose of the constitutional bar against injunctions of tax assessments and collections is to ensure that the collection of revenue is uninterrupted.
- This bill may confuse taxpayers. A taxpayer will get no deduction on the federal return for taxes paid if they pay with a bond until the bond is converted to a payment of tax, at which time interest will be due. Further, taxpayers can stop the running of interest by paying the proposed deficiency under protest (automatic claim for refund), and if they are successful, the overpayment is refunded with interest to the taxpayer or credited against other liabilities. Taxpayers that choose to post bonds rather than pay the proposed assessment under protest will earn no interest if they prevail and the bond is returned.
- This bill would prevent the collection by FTB of any amount due while an action is pending. FTB collects delinquent child support and certain other non-tax obligations. Prohibiting the collection of these non-tax debts conflicts with the policy to collect these amounts as unpaid taxes.

Implementation Considerations

This bill would raise the following implementation considerations.
Department staff is available to help the author resolve these concerns.

- It is unclear how this bill would apply to assessments or collection actions taken prior to the effective date of this bill (January 1, 2000). Further, it is unclear whether this bill would apply to proposed assessments or only to final assessments.
- It is unclear whether the prohibition from collecting while an action is pending would prevent the collection of subsequent assessments on the same tax year (e.g., assessments based on information from the Internal Revenue Service).
- It is unclear whether the "judge of the court hearing the action" means any superior court judge in the jurisdiction in which the action is filed or whether it means the trial court judge.
- The bill departs from the Code of Civil Procedure rules (Bond and Undertaking Law) regarding hearings for bonds and yet supplies no

procedure for the Attorney General and the "judge of the court hearing the action" to reach agreement regarding the amount of the bond. Under the Code of Civil Procedure, the petitioner must post an undertaking of twice the amount of the money judgment. If a surety posts a bond, the amount of the bond must be $1\frac{1}{2}$ times the amount of the money judgement.

- The bill would require the taxpayer to pay the department "all amounts due from the applicant to the state." It is unclear whether this would require the taxpayer to pay amounts other than income tax owed to the state (i.e., employment taxes, sales taxes, delinquent child support or certain other non-tax debts) or just tax, interest and penalties related to the contested assessment.
- Since this bill would allow taxpayers to initiate a lawsuit by posting a bond rather than paying the full liability, more taxpayers may take their cases directly into court without adjudication before the BOE. This would result in increased litigation workloads.

FISCAL IMPACT

Departmental Costs

The departmental costs associated with this provision are unknown. The costs could increase, however, to the extent that more taxpayers litigate.

Tax Revenue Estimate

This bill would not result in any identifiable impact to tax revenues. It is not possible to project the response of taxpayers to the posting of bonds for their tax liabilities. However, to the extent bonds are used, rather than cash payments, during the course of resolving disputes with the department, the collection of general fund revenues will be delayed.

BOARD POSITION

Pending.